IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

No. 79-584

RESEARCH EQUITY FUND, INC.,
Petitioner,

v.

THE INSURANCE COMPANY OF NORTH AMERICA,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

RESPONDENT'S REPLY TO SUPPLEMENTAL BRIEF FOR PETITIONER

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PRESS OF BYRON S. ADAMS PRINTING, INC., WASHINGTON, D. C.

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Pursuant to Rule 24(5) of the Rules of this Court, this responsive brief addresses the supplemental brief for petitioner filed in the within matter. Said supplemental brief for petitioner addressed the brief *amicus curiae* of the United States, filed on February 29, 1980, in response to the Court's Order of January 7, 1980, inviting the Solicitor General to file a brief expressing the views of the United States in this case.

The government's brief, while critical of the opinion of the court below, concluded that the SEC believed that review by this Court at this time was not essential in light of the SEC's rule-making authority.

Petitioner makes two points in its supplemental brief. Petitioner first argues that the government's position assumes that the decision interprets the existing Commission regulations under Section 17g rather than the statute itself. The second point addressed in petitioner's supplemental brief is that any rule making done by the SEC in this matter would hardly cure the problem because such regulations are not retroactive.

I.

SECTION 17g OF THE INVESTMENT COMPANY ACT OF 1940 REQUIRES NO BOND BUT MERELY PERMITS THE SEC TO REQUIRE BONDING BY RULES AND REGULATIONS.

Petitioner's supplemental brief argues that the opinion of the Court of Appeals rests quite clearly on statutory interpretation as opposed to the interpretation of the rules and regulations promulgated pursuant to the enabling legislation.

Section 17g of the Investment Company Act of 1940 merely permits the Commission to enact rules and regulations requiring bonding of any officer or employee of a registered management investment company who may singly, or jointly with others, have access to securities or funds of any registered company.

The opinion of the Court below is set forth as Appendix A to the petition in the within matter.

Reference to said opinion clearly demonstrates that the Court below considered both the statute and the regulation. (Petition, p. 7a.) The Court below noted that interpretation of a bond to provide coverage beyond its literal terms is permissible only to the extent that such coverage is required by the statute. Rule

17g-1 requires that management investment companies obtain coverage against larceny or embezzlement committed by its officers and employees.

The trial court concluded that the provisions of the trading loss exclusion were unambiguous. Research Equity now asks this Court to rewrite the bonds even though they were purchased by Winfield with the full knowledge that it was not purchasing trading loss coverage and that it was saving a premium by doing so. California has long recognized that an insured must pay a premium for the coverage afforded, and the payment of a premium when due is the essence of an insurance contract. *Methvin* v. *Fidelity Mutual Life Association* (1900) 129 Cal. 251; *Burton* v. *Columbian National Life Insurance Company* (1912) 20 Cal. App. 21.

II.

THE SEC BELIEVES THAT IT MAY PROPERLY REGULATE IN THIS AREA AND IN FACT HAS DONE SO.

Petitioner argues that if the opinion of the court below prevails, any future regulations by the SEC in this area would be struck down.

In reply it should be pointed out that the SEC has already regulated in this area, and such regulation, although inapplicable, was in effect at the time the bonds were written.

Rule 17g-1(e) provides:

> "Where the registered management investment company is an unincorporated company managed by a depositor or investment advisor, the terms 'officer' and 'employee' shall include, for the purposes of this rule, the officers and employees of the depositor or investment advisor."

Winfield was at all times herein mentioned a corporation organized and existing under the laws of the State of Delaware (FF 2.), and consequently this section is inapplicable.[1] Furthermore, WGF was registered as an open-end diversified management investment company under the Investment Company Act of 1940. (FF 3.) Furthermore, WGF was the only entity on the Winfield bonds which had to be bonded under Rule 17g-1. (FF 159.) A copy of WGF's bond was filed with the SEC. (FF 160.) The SEC never complained concerning the adequacy of the Winfield bonds. (FF 163.) The SEC never gave appropriate notice or conducted a hearing with regard to the inadequacy under Rule 17g-1 of the Winfield bonds issued by INA. (FF 165.)

Thus, not only has the SEC partially regulated in the area, the evidence before the trial court also demonstrated that the SEC in fact reviewed the bonds and raised no objection.

Congress has not enacted any legislation requiring bonds for investment advisers. Indeed, Congress has rejected proposed legislation to authorize the SEC to require bonds for investment advisers. The Commission, however, may regulate investment companies and require such companies to bond those who advise such companies. To date, the Commission has not enacted any rule requiring a corporate investment company to bond its advisers. As the United States has noted, this problem may be solved by the adoption of proper rules. The solution to this problem should be left to the Commission.

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[1] The detailed findings of fact and conclusions of law are set forth in Appendix B to the Petition. The Court of Appeals determined that the findings of the District Court are fully supported by the evidence. (Petition, page 6a.)

III.

PETITIONER'S PREDECESSOR DELIBERATELY AND INTENTIONALLY ELECTED TO EXCLUDE TRADING COVERAGE. COVERAGE SHOULD NOT BE IMPOSED RETROACTIVELY WHERE THE INSURED PAID NO PREMIUM FOR SUCH COVERAGE AND DID NOT INTEND TO PURCHASE SUCH COVERAGE.

The United States has pointed out that the problem of requiring coverage for employees of investment advisers "can be corrected by the Securities and Exchange Commission through rule making in the exercise of its 'broad regulatory authority over the business practices of investment companies.' " (Brief of the United States, *amicus curiae*, page 5.) As further noted, "the Commission is currently developing rule proposals and is considering the initiation of rule making proceedings." (Brief of the United States, page 7.) Petitioner argues that such regulation will not be retroactive and unless the instant decision is reversed, "investors in mutual funds that have bonds like petitioner's will have been stripped of the bonding protection for losses suffered in the past through the dishonesty of portfolio managers." (Supplemental Brief of Petitioner, page 3.) We find petitioner's newly-developed concern for investors to be somewhat out of place considering the trial court's findings of fact and conclusions of law in the instant case.

The trial court specifically found:

> "34. Brokers Blanket Bond Form 14 broad form excludes losses resulting from trading from insuring clauses A, B, and C, and the exclusion may be removed by the payment of an additional premium."

> "69. Robert Lovejoy executed an application for Brokers Blanket Bonds in 1968 and therein

represented A. Stephen Sanders to be an employee of Winfield & Company."

"115. WGF did in fact exercise its independent judgment as to the amounts and coverage to be purchased under the bonds."

"117. Lovejoy had discussions with the board of WGF regarding the bonds not less than annually. He would review the bond coverage then in effect and ask the board to make a determination as to its adequacy."

"136. Hopkins testified trading loss coverage was discussed with the various and successive representatives of WGF.

"137. Trading loss coverage was available.

"138. Hopkins asked INA for quotes on trading loss coverage and obtained the same.

"139. When Hopkins reviewed the insurance coverage with WGF, he asked them whether they wished to purchase trading loss coverage and they rejected the same.

"140. The additional premium for trading loss coverage is 35% to 50% over the basic cost.

"141. Hopkins talked to Lovejoy at least annually regarding the trading loss exclusion, and Lovejoy indicated that he did not want to pay the additional premiums to delete the exclusion."

"144. Correspondence between Hopkins and Winfield & Co. made reference to the fact that Winfield & Co. had no coverage on trading losses.

"145. WGF and Winfield & Co. were aware that they did not purchase trading loss coverage.

"146. There were occasions when Hopkins told Winfield certain forms of insurance were available, but they rejected it. Coate made the decision not to remove the exclusion. Hopkins talked about

the trading loss exclusion with Lovejoy, Coate, and Jack Deignan at least annually, and they were aware that they did not have trading loss coverage.

"147. With regard to Exhibit BN, Hopkins prepared the agenda of items to discuss with Winfield representatives with regard to bond coverage. On that exhibit, following the words 'trading loss' appears the word 'no'. That word was inserted during Hopkins' discussion with the Winfield representatives who indicated to him that they did not want trading loss coverage."

"150. On January 10, 1969, WGF was aware that it had no trading loss coverage."

"185. WGF recognized that it was trading."

"192. The directors of Winfield & Co. were aware that the purchase and sale of securities constituted trading."

The District Court concluded:

"13. The insureds had no reasonable expectation that the losses of the character sustained by them in this case would be covered under INA's bonds."

When it was purchasing coverage and paying premiums for such coverage, petitioner's predecessor in interest elected not to obtain trading loss coverage for itself or employees of its investment adviser. It deliberately and intentionally elected to exclude such coverage. Now, petitioner requests that this Court impose coverage which petitioner's predecessor chose to exclude and for which it never paid a premium. If there is a problem in the area which should be solved, it should be done prospectively so that insurers and insureds alike will know that such coverage must be provided and that a reasonable premium may be charged for the risk which is insured. Congress has not

previously enacted legislation requiring bonds for investment advisers and where the Commission has not to this point enacted regulations covering the instant situation, any change in the law should be done prospectively. The United States Court of Appeals for the Ninth Circuit properly affirmed the judgment which was predicated upon the reasonable expectation of the parties. This Court should not require or impose coverage which petitioner deliberately chose to exclude.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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